

### Revenue Ruling 76-287

July 1976

**Three-family dwelling unit rented to relative at less than fair rental value.** The application of section 183 of the Code is illustrated with respect to allocation and allowance of deductions by the owner of a three-family dwelling, one unit being owner occupied, one unit being rented to a relative at less than fair rental value, and the remaining unit being rented at fair rental value.

Advice has been requested under the circumstances described below, regarding the application of section 183 of the Internal Revenue Code of 1954 to the allowance of deductions for expenses incurred for the maintenance of a multiple family dwelling.

The owner of a three-family dwelling occupies one-third personally, rents one-third to a relative for \$1,000 for the year, and rents the remaining one-third to an unrelated person for \$2,400, which is the annual fair rental value for each of the units. The annual expenses for the entire dwelling are as follows: \$900 interest, \$1,500 real estate taxes, \$1,200 maintenance and utilities, and \$1,500 depreciation.

Section 262 of the Code provides that, except as expressly provided in chapter 1 of subtitle A, no deduction shall be allowed for personal, living, or family expenses.

Section 183 of the Code, which is the exclusive provision for allowing as deductions any expenses attributable to activities not engaged in for profit, provides that no deduction attributable to such activity will be allowed except: (1) the deduction allowable under chapter 1 of subtitle A for the taxable year without regard to whether such activity is engaged in for profit, and (2) a deduction equal to the amount of the deductions that would be allowable under chapter 1 of subtitle A for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable under (1) above.

Section 162(a) of the Code provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.183-1(d) (1) of the Income Tax Regulations provides, in part, that in order to determine whether, and to what extent, section 183 of the Code and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may be one activity. In ascertaining the activity, or activities of the taxpayer, all the facts and circumstances of the case must be taken into account.

Section 1.183-1(d) (2) of the regulations provides the rules for allocation of expenses if it is determined, after taking into account all the facts and circumstances, that section 183 of the Code and the regulations thereunder apply to a particular taxpayer's activities. This section of the regulations provides, in part, that where property is used in several activities, and one or more of

such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

Under the facts and circumstances in the instant case, the renting of the unit to a relative for less than fair rental value is one activity and the renting of the unit to an unrelated person for fair market value is a separate activity. The renting of the unit to the relative is an activity not engaged in for profit under section 183 of the Code. The renting of the unit to the unrelated person is a business activity. Thus, deductions must be allocated on a reasonable and consistently applied basis and may be made on a unit basis.

Under the particular facts and circumstances, allocation of the expenses and depreciation on a unit basis is as follows:

|                              |        | Personal use 1/3<br>allocable to section<br>262 | Business use 1/3<br>allocable to section<br>162 | Activity not<br>engaged in for<br>profit 1/3 allocable<br>to section 183 |
|------------------------------|--------|---|---|--|
| Interest                     | \$ 900 | \$ 300  | \$ 300  | \$ 300   |
| Real Estate                  | 1500   | 500   | 500   | 500  |
| Taxes                        |        |   |   |  |
| Maintenance<br>and Utilities | 1200   | 400   | 400   | 400  |
| Depreciation                 | 1500   | 500   | 500   | 500  |
| Total                        | \$5100 | \$1700  | \$1700  | \$1700   |

Section 1.183-1(b) (1) of the regulations provides, generally, that if an activity is not engaged in for profit, deductions are allowable under section 183(b) of the Code in the following order and only to the following extent: (1) amounts allowable as deductions during the taxable year without regard to whether the activity was engaged in for profit are allowable in full; (2) amounts that would otherwise be allowable if the activity were engaged in for profit that would not result in an adjustment to the basis of the property if allowed are allowed only to the extent the gross income derived from the activity exceeds the deductions allowed or allowable in (1); and (3) amounts that would otherwise be allowable if the activity were engaged in for profit that would result in an adjustment to the basis of the property if allowed are allowed only to the extent the gross income derived from the activity exceeds the deductions allowed or allowable in (1) and (2).

Thus, if the activity is not engaged in for profit, (A) interest and taxes are deductible in full because they would otherwise be allowable under sections 163 and 164 of the Code; (B) operating expenses are deductible to the extent that the gross income therefrom exceeds the interest and taxes, and (C) depreciation is deductible to the extent that gross income therefrom exceeds the interest, taxes, and operating expenses.

Section 62 of the Code sets forth those deductions to be subtracted from gross income in computing adjusted gross income in the case of an individual. In general, under section 62(1) the deductions allowed by chapter 1 of subtitle A of the Code that are attributable to a trade or business carried on by the taxpayer, except as an employee, are subtracted from gross income in computing adjusted gross income. Under section 62(5) the deductions allowed by section 183 that are attributable to property held for the production of rents are subtracted from gross income in computing adjusted gross income.

However, since deductions allowed under section 183 of the Code cannot be attributable to a trade or business, section 62(1) does not apply. Property is only held for the production of rents

when the primary purpose in holding the property is to produce rental income in excess of the expenses attributable to the property. In other words, there must be a profit motive. Thus, if an activity is not engaged in for profit under section 183(c), then the property associated with such activity is not held for the production of rents within the meaning of section 62(5).

Therefore, any deductions allowable under section 183 of the Code are to be deducted from adjusted gross income in computing taxable income and may be taken only if the taxpayer itemizes deductions. Rev. Rul. 75-14, 1975-1 C.B. 90.

Accordingly, in the instant case, since one-third of the expenses and one-third of the depreciation are attributable to the activity not engaged in for profit, \$300 of interest and \$500 of real estate taxes (deductions that are specifically allowable under sections 163 and 164(a) of the Code), and \$200 of maintenance and utilities (the difference between the \$1,000 gross income from the activity and the \$800 deduction for interest and taxes above) are allowable as deductions under section 183.

Further, the expenses and depreciation that are attributable to the personal occupancy by the owner of the dwelling are nondeductible personal, living, and family expenses under section 262 of the Code. However, amounts otherwise allowable as deductions during the taxable year under chapter 1 of subtitle A are allowable to the full extent allowable by the relevant Code sections. Accordingly, interest of \$300 and real estate taxes of \$500 are deductible under section 163 and section 164, respectively, if the taxpayer itemizes deductions.

Also, the expenses and depreciation (\$1,700) that are attributable to the business use of the dwelling are deductible under sections 162 and 167 of the Code. These amounts are deductible from gross income in computing adjusted gross income.